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How We Rate Sovereigns

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The sovereign debt crisis in Europe, and high-profile budget debates in countries such as the United States, have made sovereign creditworthiness a major issue in recent times and highlighted the role of credit ratings agencies in assessing and opining on this issue.

The concept of sovereign default risk is not a new one, of course, with many high-profile defaults having occurred throughout history, including in the recent past the Latin American crisis in the 1980s and the Russian crisis in 1998.

Sovereign government bonds, which represent over 40% of the stock of bonds that have been issued globally, are an important asset class held by investors around the world. It is, therefore, important that investors have globally recognized and consistent benchmarks to aid in their investment decisions. We believe the liberalization of financial markets as well as the force of economic globalization have made the demand for such benchmarks higher than ever.

In this context, credit ratings agencies can play an important role in providing investors with an independent opinion about the creditworthiness of individual sovereigns. Ratings agencies help reduce the information asymmetry between issuers and investors. We believe ratings contribute to market efficiency, with ratings themselves available free of charge for investors, other market participants, and the public generally.

This article provides an overview of how Standard & Poor's analyzes sovereign risk as the basis for that sovereign's rating, and describes the process involved in assigning such rating to the sovereign. For a more detailed overview of Standard & Poor's sovereign credit rating methodology, see "Sovereign Government Rating Methodology And Assumptions," published June 30, 2011.

Updated Criteria For Rating Sovereigns

In June 2011, we updated our criteria for rating sovereign governments. The main objectives of the update were to provide market participants with a clearer picture of how we rate sovereigns and to further incorporate the experiences of the 2008-2009 global recession and its aftermath. The update was part of a series of transparency initiatives we have undertaken to help investors better understand the meaning of our ratings, how we arrive at particular ratings, and what can cause ratings to change.

The criteria build on the robust long-term track record of our sovereign ratings. Since 1975, an average of 1% of investment-grade sovereigns have defaulted on their foreign-currency debt within 15 years, compared with 30% of those in the speculative-grade category. An October 2010 IMF report found that "CRAs quite accurately rank sovereign default risk". The IMF report also noted that all sovereigns that have defaulted since 1975 had speculative-grade ratings at least one year before default.

The updated criteria explain how we assess the five key factors underlying our sovereign rating analysis, and how those factors combine to help us to arrive at a sovereign rating. In particular, the criteria include an enhanced measure of a sovereign's contingent liabilities related to the financial sector and articulate the special credit characteristics of sovereigns within a monetary union.

As the main objective of this criteria update was to provide more clarity on our methodology while keeping the same fundamentals, its implementation had only a limited impact on our sovereign foreign-currency ratings.

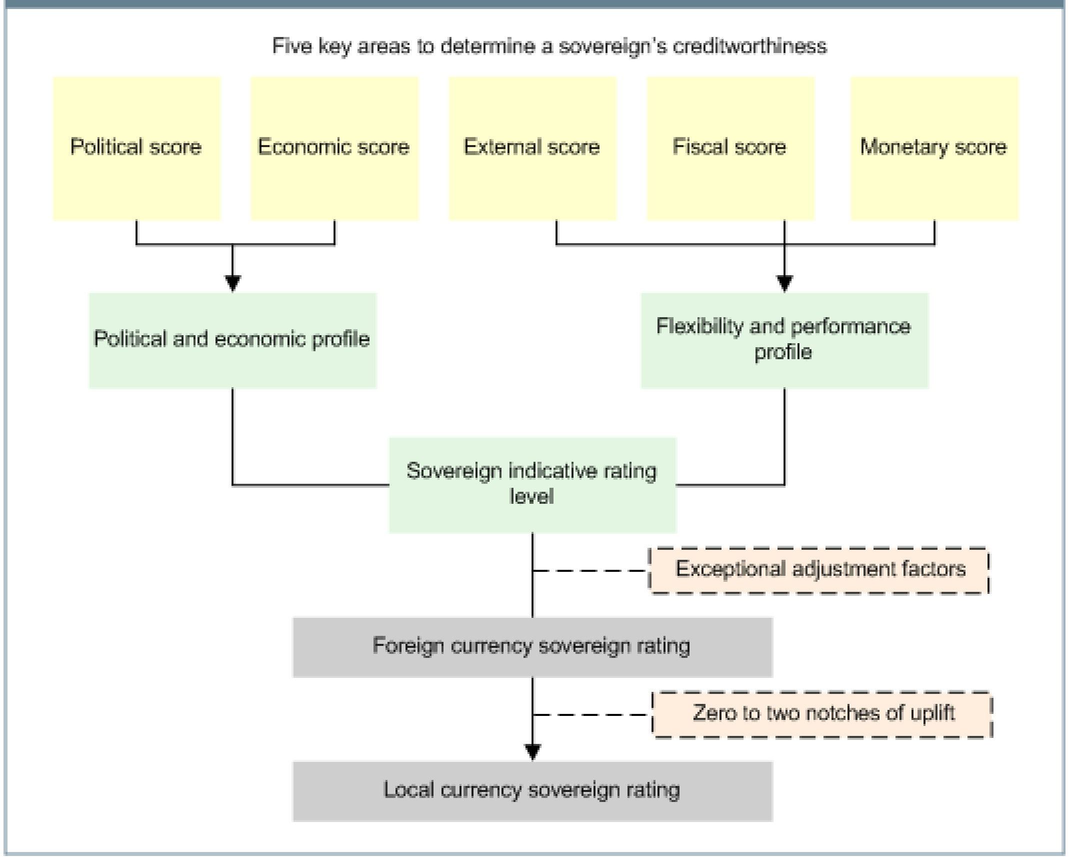
How We Apply The Criteria

Our sovereign rating criteria address the factors that we believe affect a sovereign government's willingness and ability to service its debt on time and in full. Our analysis focuses on a sovereign's performance over past economic and political cycles, as well as on factors that suggest to us greater or lesser fiscal and monetary flexibility over the course of future economic cycles.

The five factors that form the foundation of our sovereign credit analysis are:

- Institutional effectiveness and political risks, reflected in the political score.
- Economic structure and growth prospects, reflected in the economic score.
- External liquidity and international investment position, reflected in the external score.
- Fiscal performance and flexibility, as well as debt burden, reflected in the fiscal score.
- Monetary flexibility, reflected in the monetary score.

Chart 1
Sovereign Rating Framework



The political score reflects our view of how a government's institutions and policymaking affect a sovereign's credit fundamentals by delivering sustainable public finances, promoting balanced economic growth, and responding to economic or political shocks. It also reflects our view of the transparency and reliability of data and institutions, as well as potential geopolitical risks.

The three factors that are the key drivers of a sovereign's economic score are our view of its income levels, growth prospects, and its economic diversity and volatility.

Three factors also drive a sovereign's external score, namely our view of the status of a sovereign's currency in international transactions, the sovereign's external liquidity, and its external indebtedness, which shows residents' assets and liabilities relative to the rest of the world.

The fiscal score reflects our view of the sustainability of a sovereign's deficits and its debt burden. This measure considers fiscal flexibility, long-term fiscal trends and vulnerabilities, debt structure and funding access, and potential risks arising from contingent liabilities. Given the many dimensions that this score captures, the analysis is divided into two segments, "fiscal performance and flexibility" and "debt burden."

The main drivers of the monetary score are our view of the monetary authority's ability to use monetary policy to address domestic economic stresses, particularly through its control of money supply and domestic liquidity conditions; the credibility of monetary policy, as measured by inflation trends; and the effectiveness of mechanisms for transmitting the impact of monetary policy decisions to the real economy, largely a function of the depth and diversification of the domestic financial system and capital markets.

Each of the five factors receives a score, using a six-point numerical scale from '1' (the strongest) to '6' (the weakest). A series of quantitative factors and qualitative considerations form the basis for assigning these forward-looking scores. The criteria then call for those five scores to be combined to form a sovereign's political and economic profile (the average of the political score and the economic score) and its flexibility and performance profile (the average of the external score, the fiscal score, and the monetary score).

These two profiles are then used to determine an "indicative rating level". We expect that our sovereign foreign-currency rating would, in most cases, fall within one notch of the indicative rating level, based on the sovereign's positioning relative to its peers. For example, for a sovereign we view as having a "moderately strong" political and economic profile and a "very strong" flexibility and performance profile, we would most likely assign a rating within one notch of 'AA-'.

Table1
Indicative Rating Levels From The Combination Of (1) The Political And Economic Profile With (2) The Flexibility And Performance Profile

		Political and economic profile										
Flexibility and performance profile	Category	Superior	Extremely strong	Very strong	Strong	Moderately strong	Intermediate	Moderately weak	Weak	Very weak	Extremely weak	Poor
Category	Score	1	1.5	2	2.5	3	3.5	4	4.5	5	5.5	6
Extremely strong	1 to 1.7	aaa	aaa	aaa	aa+	aa	a+	a	a-	bbb+	N/A	N/A
Very strong	1.8 to 2.2	aaa	aaa	aa+	aa	aa-	a	a-	bbb+	bbb	bb+	bb-
Strong	2.3 to 2.7	aaa	aa+	aa	aa-	a	a-	bbb+	bbb	bb+	bb	b+
Moderately strong	2.8 to 3.2	aa+	aa	aa-	a+	a-	bbb	bbb-	bb+	bb	bb-	b+
Intermediate	3.3 to 3.7	aa	aa-	a+	a	bbb+	bbb-	bb+	bb	bb-	b+	b
Moderately weak	3.8 to 4.2	aa-	a+	a	bbb+	bbb	bb+	bb	bb-	b+	b	b
Weak	4.3 to 4.7	a	a-	bbb+	bbb	bb+	bb	bb-	b+	b	b-	b-
Very weak	4.8 to 5.2	N/A	bbb	bbb-	bb+	bb	bb-	b+	b	b	b-	b-
Extremely weak	5.3 to 6	N/A	bb+	bb	bb-	b+	b	b	b-	b-	ccc/cc	ccc/cc

Separately, a sovereign local-currency rating is determined by applying up to two notches of uplift over the foreign-currency rating. Sovereign local-currency ratings can be higher than sovereign foreign-currency ratings because local-currency creditworthiness may be supported by the unique powers that sovereigns possess within their own borders, including issuance of the local currency and regulatory control of the domestic financial system. When a sovereign is a member of a monetary union, thus ceding monetary and exchange-rate policy to a common central bank, or when it uses the currency of another sovereign, the local-currency rating is, under our criteria, equal to the foreign-currency rating.

Process For Rating Government Issuers

Request

For government issuers, Standard & Poor's rating process is typically initiated when the issuer or its representative requests a rating for a particular debt issue.

A Standard & Poor's client business manager (CBM) typically responds to the issuer's request and enters into an agreement to rate the issuer and/or issue. All commercial matters are handled by the CBM and the terms and conditions are not negotiable.

Most sovereign issuers have rating agreements with us, but some sovereign ratings are classified as "unsolicited" because we do not have a rating agreement with the issuer. We continue to rate these sovereigns when we believe there is significant market interest in them and there is also sufficient public information of reliable quality to support our analysis and ongoing surveillance.

The initial rating process

The initial rating process typically takes four to six weeks to complete, but can run longer or shorter. This initial process begins when the contract is signed and generally ends with the publication of the rating.

The rating process consists of several discrete steps and typically includes a series of ongoing information exchanges between the ratings agency and the issuer. These interactions enable Standard & Poor's to gather the information it needs to conduct its evaluation and form its rating opinion.

The analytical team and rating committee

Standard & Poor's assigns a lead analyst and generally a backup analyst to begin the rating process. Standard & Poor's selects the analysts for each rating assignment based on their knowledge of and experience with a particular issuer, sector, industry, or the type of debt obligation being issued.

To strengthen the evaluation process, Standard & Poor's appoints a committee of generally five to seven members, including the primary and backup analysts. The role of the committee is to review and assess the lead analyst's rating recommendation for a new rating, a rating change or a rating affirmation, to provide additional perspectives in the analysis, to provide checks and balances against conflicts and undue influence, and to provide consistent application and adherence to the ratings criteria.

In addition, Standard & Poor's appoints a committee chairperson who is responsible for overseeing the committee process and making sure that the relevant criteria are applied consistently.

Pre-evaluation

Prior to meeting with the issuer's management, the analysts examine the issuer's publicly reported financial information and any other relevant information provided by the issuer. This pre-evaluation helps analysts identify and define additional information needed from the issuer as well as specific matters the issuer should be prepared to address at the management meeting.

Management meeting

The analytical team meets with representatives of the issuer. In the case of a sovereign, they typically meet with representatives from the ministry of finance or the debt management office and other relevant departments like labour or social security. The analytical team also typically meets with central bank and private sector representatives. The purpose of the meeting is to enable Standard & Poor's analysts to probe pertinent information in greater detail, including public information as well as other information that may be provided by the issuer. The discussion usually takes place in person at the issuer's offices, but in some cases can take place at Standard & Poor's offices, over the phone, or a combination of all of these. At the conclusion of the meeting, Standard & Poor's will outline the committee process and provide an indication as to how long the process may take.

Committee evaluation

The lead analyst presents his or her assessment to the committee, which discusses, questions, and debates the analyst's conclusions and evaluation of certain risk factors. The final rating assigned by the committee is primarily determined by applying the rating criteria to the information that the analysts have collected and evaluated.

However, rather than providing a strictly formulaic assessment, Standard & Poor's factors into its ratings the perceptions and insights of its analysts based on their consideration of all of the information they have obtained. This process helps the committee to form its opinion of an issuer's overall ability to repay obligations in accordance with their terms.

Notification of issuer

Standard & Poor's generally notifies the issuer of the rating and outlook, and provides a rationale for the major factors supporting the rating. If an issuer disagrees with the rating conclusion, Standard & Poor's may allow for an appeal only if the issuer can provide new and significant information to support its point of view. If an appeal is granted, Standard & Poor's will reconvene the committee, review the new information, and vote again on the rating.

Publication

For public ratings, in most cases, Standard & Poor's publishes a press release announcing the final rating along with the rationale, distributes it to the media, and posts it on www.standardandpoors.com. To verify that the factual information is correct and that no confidential information has inadvertently been disclosed, Standard & Poor's may provide the issuer with a copy of its report for a review prior to releasing it to the public. The information in the draft is confidential and should not be disclosed or released prior to its publication by Standard & Poor's. The advance copy time period is based upon the domicile of the Primary Analyst as follows: 12 hours in the EU, and two hours in all other regions. When the Primary Analyst is based in the EU, the 12 hour period may not be shortened.

However, if the rating is provided on a confidential basis, the rating is not published and Standard & Poor's disseminates the rating only to the rated entity.